

/THE INVESTMENT STRATEGY OF MULTINATIONAL CORPORATIONS/

by

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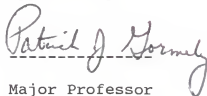
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It is not an easy job to complete a work of this sort. One who attempts a work like this is singularly dependent upon the counsel and criticism of advisors and the encouragement of friends.

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# The Investment Strategy of Multinational Corporations

## Introduction

A Multinational Corporation (MNC) is a firm that controls and manages production establishments located in at least two countries.<sup>1</sup> MNC can be divided into three types. A horizontally integrated MNC turns out essentially the same line of goods or services from each facility in several different locations. A vertically integrated MNC produces outputs in some facilities which serve as inputs in other facilities located across national boundaries. A conglomerate MNC produces unrelated products in facilities located in at least two countries.

MNCs play vital roles in the world economy. The U.S. Department of Commerce reported that for 1981 the total stock of direct foreign investment held by developed-market

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1. There are many definitions of MNC, the simplest one is that MNC is any firm which owns outputs of goods or services originating in more than one country. For further detail, see Peter J. Buckley and Mark Casson (eds.), The Economic Theory of Multinational Enterprise (London: The Macmillan Press Ltd, 1985).

There are many other names for MNCs, including transnational corporation, international business, multinational enterprise and multinational firm. Sometimes multinational firm refers to individual subsidiary of a MNC.

economies was more than \$528 billion.<sup>2</sup>

Recently, the activities of MNCs have been the focus of considerable policy debate. There is a vast literature and considerable empirical work has been done, but MNCs remain a controversial topic.

This paper analyzes the advantages and motives of MNCs' foreign direct investment programs from the standpoint of International Economics and industrial organization. As a firm, the MNC's primary motivation for being multinational is profit maximization. The first section of this report is a brief review of the theories of foreign direct investment of MNCs. In the second section, the advantages and benefits of two types of MNC organization are discussed. In the third section, the cost advantages of the MNCs will be analyzed. In the fourth section, revenue-enhancing strategies will be analyzed. In the fifth section, the relationship between the home country and MNC is discussed. In the sixth section, the host-countries' interests and policies are considered. Finally, section seven examines the reasons for the emergence of MNCs from developing countries.

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2. U.S. Department of Commerce, International Direct Investment: Global Trends and the U.S. Role. Aug. 1984, p. 45.

## I. Theory of Foreign Direct Investment of MNC

There are several theories of foreign direct investment. In the traditional Heckscher-Ohlin model of international trade, countries in effect trade factor services, reflecting their different factor endowments. They can do this either by movement of goods produced with different factor proportions or by movement of the factors. Which route is taken depends on various incentives.

Tariffs and transportation costs tend to promote factor movement instead of trade; barriers to the movement of factors push toward trade instead of factor movement. Tariffs create an incentive for foreign exporters to transfer production facilities to the country that created the tariff barrier; thus the trade barriers induce foreign firms to become multinationals.

Unlike the Heckscher-Ohlin trade theory, which states that a country's pattern of trade is determined by its factor proportion ( a country exports products which use intensively its abundant factor and imports products which utilize intensively its scarce factor), theories of foreign direct investment focus on the investment behavior of firms instead of countries.

Krugman claims that foreign direct investment must be a response to market failure, that it generally occurs in oligopolistic markets, and that a model of MNC must be a model of imperfect competition.<sup>3</sup>

In a world of perfect competition there would not be foreign direct investment. When there are numerous producers and buyers of a given product any one seller or buyer has no influence on the market. There is no product differentiation. Manufacturing know-how and market information are well shared by producers and consumers. In such a perfectly competitive market, a foreign investor would certainly be at a disadvantage relative to indigenous firms.

Hymer (1960) postulated that foreign direct investment occurred most prominently in those industries with oligopolistic structures, in which there are only a limited number of firms with superior product knowledge, and the firms are producing within the range of economies of scale. He (1970) also argued that " Multinational Corporations are typically large firms operating in imperfect markets." In Hymer's view a foreign investing firm's strength lies in the production economies of scale which allow it to operate

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3. Paul R. Krugman, "The 'New Theories' of International Trade and the Multinational Enterprise" , in Kindleberger and Audretsch, (eds.), The Multinational Corporation in the 1980s (Cambridge: The MIT Press, 1983), p. 57.

efficiently.<sup>4</sup>

In order to compete with indigenous firms which possess innate strength such as knowledge of the local environment, market and business condition, and face favorable government policies, MNCs must have some compensating advantages.

The imperfection of markets provides these advantages. Imperfect competition in factor markets, including access to patented or proprietary know-how, capital and managerial skills, provides an advantage to MNCs. Imperfect competition in goods markets, including superior marketing skills, product differentiation and administered pricing, can increase MNCs' revenue. Imperfection in the financial market involves uncertainty, especially the changes in exchange rates, changes in exchange controls, changes in tax rates and other financial measures that segment national markets for money and finance. These can give the MNC an extra advantage, for MNCs are able to finance internationally with lower interest rate, to divert exchange risk and to avoid tax through transfer pricing.

The product life cycle theory of foreign direct investment, developed by Vernon in the 1960s, explains foreign direct investment by firms whose advantage is based upon

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4. See Yoshi Tsurumi, Multinational Management, 2nd edition (Cambridge: Ballinger Publishing Company, 1984), pp. 193-194.

product technology. Vernon uses this theory to explain U.S. direct investment.<sup>5</sup> According to this theory, when a new product is first created and marketed in the innovation stage, it is likely that the new product is sold only in the home country; when the sales grow and foreign demand for the product develops, firms begin to export the new product to meet the small foreign demand; over time, foreign demand increases to the extent that establishing a local manufacturing plant is efficient and profitable. Furthermore, when the technology becomes routinized, local firms will attempt to enter the market, and the local government may create tariffs or barriers to trade to encourage local manufacturing. In order to defend the established markets, the exporting firms shift production facilities to foreign countries.

Location theory explains how transportation costs affect geographical production and location patterns.<sup>6</sup> Location factors provide the motives for the different types of investment, including market-induced investment, raw-material-induced investment, low-labor-cost-induced investment. A study shows that the major recipients of foreign direct

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5. Raymond Vernon, Sovereignty at Bay: The Multinational Spread of U.S. Enterprises (New York: Basic Books, 1971).

6. See Enders and Lapan, International Economics (Prentice-hall, 1987).

investment are developed countries. In 1980, of the total world stock of foreign direct investment, 71% was located in the developed countries.<sup>7</sup> Foreign investment in the developing countries was mostly distributed to those countries with large protected markets, to countries where there are abundant raw-material resources like oil and copper, and to countries where labor cost is low and infrastructure is relatively well-developed like Singapore and South Korea in the past.

## II. The Organization of Multinationals: Integration vs. Local Responsiveness

MNC is involved in a range of activities -- financing, production and marketing -- that are coordinated or integrated across national borders by headquarters. MNC integration is defined as the specialization of plants in different countries into a multinational production and/or distribution network. Integration involves product and/or process specialization. Product specialization means that instead of producing a complete product range in each country the MNC manufactures in each country only a part of a common multinational product range for the global market. Process specialization in a

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7. See John M. Stopford and John H. Dunning, The World Directory of Multinational Enterprises: Company Performance and Global Trends (Detroit: Gale Research, 1983), p. 12.

multi-stage manufacturing process involves the specialization of plants to only some of the stages in a product's manufacturing process. Integration can increase manufacturing efficiency through centralized decision making.

The primary advantage of MNC integration lies in its ability to allocate resources across subsidiaries through a globally maximizing network. As the size and importance of foreign operations increase, the need to coordinate and integrate also increase, particularly in manufacturing, research, and financing. The benefits from transferring relevant information and experience from one subsidiary to another are high; the professional management and standardized administrative procedures may allow MNCs to maximize operational efficiency; the planning and budgeting systems of a MNC provide important channels for the incorporation of subsidiaries' goals and objectives into the overall strategic goals of the MNC; integrated costly R&D can avoid duplication and spread the costs over several subsidiaries; coordination of export activities may improve competitive strength and returns. Through integration worldwide, considerable scale economies can be generated and realized.

Under the integration strategy, centralized management dominates. Key decisions affecting MNC's operations such as product development, production programming, changes in

production processes, plant expansion or concentration, new product introduction, acquisition, and even marketing, are made in the headquarters. Decisions are taken from the perspective of overall systemwide optimization. Each subsidiary plays a well-defined part in the integrated system, particularly for manufacturing, engineering and R&D, and provides feedback into the major decisions that affect it.

Integration can provide the MNC competitive strength when responding to competitive activities of rivals. This may explain why some MNCs prefer full-ownership -- full control of subsidiaries -- rather than licensing and other forms of technology transfer. Moreover, integration can improve the MNCs' bargaining position and provide more clout when confronting host governments.

However, it must be realized that the larger the spread of the multinational network, the more difficult it will be for the MNC to coordinate. Monitoring costs are likely to increase, for the structural complexity increases the difficulties of the organizational management. Internalizing transactions to exploit better competitive advantages results in the added cost of building and maintaining the complex structure and management processes that administer the internalized transactions, while lack of internal control within such complex structures may result in operating

inefficiency. The added costs of increasingly large and complex structures is the reason why there are numerous MNCs rather than just one enormous MNC.

Since subsidiaries are sometimes competing with local firms, headquarters must have the ability both to coordinate strategies and also to assign different strategic missions to different subsidiaries as competitive conditions demand. This calls for flexibility in the headquarter-subsidiary relationship.

The involvement of host government intervention further complicates the headquarter-subsidiary relationship. In the words of Prahalad and Doz,

In businesses where host governments would like to influence strategy at the local, subsidiary level, global coordination and control can become complex. Implementing choices of production location, technology, transfer prices, product range, and pricing dictated by global competition can become problematic in such a situation.<sup>8</sup>

To balance the needs for global coordination with the needs for local responsiveness becomes inevitable. Prahalad and Doz have maintained that the pressures for local

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8. C. K. Prahalad and Yves L. Doz, The Multinational Mission (New York: The Free Press, 1987), p. 165.

responsiveness arise from the differences in customer needs, differences in distribution channels, availability of substitutes, and host government demands.<sup>9</sup>

Local responsiveness allows the subsidiaries to behave as if they are local companies. In a local responsiveness strategy there are fewer pressures on the subsidiaries to maximize economic efficiency for the MNC as a whole. Subsidiaries can adapt to local market conditions, better assess local demand, and satisfy customers' needs for differentiated products. In autonomous subsidiaries key decisions are made locally as a function of local circumstances, toward local optima, unlike decisions in the integrated network which have to contribute to a system-wide optimum.

However, local responsiveness does not eliminate the need for headquarter coordination of financing, R&D, pricing, purchasing and marketing. The success of the MNC over purely national competitors lies in its ability to exploit common capacities and proprietary knowledge in multiple national markets to reduce costs and increase revenues. The choice and degree of centralized management or local responsiveness is determined by the profit maximization systemwide.

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9. Ibid. pp.20-21.

Nevertheless, the diversity of national situations, economic, political and cultural, and of national policies is such as to frustrate attempts at generalization. Such immense diversity makes the choice of an appropriate investment decision by MNC difficult.

### III. Cost-saving Advantages of MNCs

During the past decades, especially after 1960s, managers in business have come to realize and accept a new reality: global competitors and global competition in many world product markets. Coincident with these has been a realization that developing and implementing global strategies require a good analysis of cost and of the technological advantages of competitors. The ability to compete in the global marketplace requires not only the skill to foresee the everchanging competitive advantages in a given business, but equally important, the ability to reallocate resources to maintain and in some cases to regain competitiveness.<sup>10</sup>

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10. For a further discussion of MNC strategic management, see D. F. Channon and M. Jalland, Multinational Strategic Planning (London: The Macmillan Press Ltd, 1979), and W. H. Davidson, Global Strategic Management (New York: John Wiley & Sons, 1982).

In the pursuit of strategic goals, MNCs have to consider changes in technology, economies of scale, factor cost advantages, global distribution of market, and many other factors that affect the costs of production abroad. If costs of production abroad are greater than those of domestic production plus transportation costs, then MNCs will not invest abroad but simply produce at home and export to foreign markets.

In reality, the decision to invest abroad is a very complicated issue since not only economic variables but also political factors play an important role. Planning and forecasting are important but very difficult. Some factors change every day, and some factors may even conflict with others. And the dynamics of global competition requires MNCs consider not only the short run but also the long run when an investment decision is made.

The factors considered in determining the lowest possible cost are the following:

#### **1. Factor Cost Advantages**

i). Factor cost advantages are often referred to as location-specific advantages. Different factor prices across countries may be responsible for the growth of Multinationals. According to the product cycle theory, when the technology for

producing certain products becomes routinized, it will be cheaper to transfer production overseas, where the factor costs (mainly labor cost) are lower. Included in factor cost advantages are labor cost differentials between alternative manufacturing locations. Low labor cost contributes to labor-induced foreign direct investment. In a labor-intensive industry the net cost differential that can accrue to a manufacturer is enormous. In most of the developing countries the wage rate is only a small fraction of the developed ones. By producing in the low-wage countries MNCs are able to greatly reduce the cost of production, given the same fixed costs and that there are not great differences in productivity levels.

The labor-oriented investment is justified by the profitability and the rationality for the advanced countries to contract their labor intensive industries and transfer the location of production to low-wage countries where cheaper labor cost prevails.

ii). Availability and access to cheap sources of raw materials or semifinished materials is another location-specific advantage. Raw-material-induced investment is an important type of foreign direct investment. The availability of natural gas in the Middle East is an example. Access to raw materials and a cheap and plentiful supply of energy can

induce MNCs to locate in a specific area. Petrochemical plants, aluminum smelters, paper mills tend to be located where the raw materials are available.

The natural resources-oriented investment results from the investing countries' desire to obtain the products which are comparatively disadvantageously produced at home or domestically unavailable. This kind of investment causes growth in vertical specialization between producers of manufactures and primary products.

One characteristic of Japanese MNCs is their endeavor to invest in developing countries with the object of securing increased supplies of primarily products which are vitally important to the Japanese economy. A large part of Japanese investment was directed towards natural resources that are very scarce in Japan such as oil, natural gas, iron ore, coal, copper, bauxite and other metals. Wood and timber also have high priority.

The distribution of Japanese outward investment differs significantly from that of other industrialized countries. The Japanese invested heavily in Southeastern Asia, Latin America, and Australia where labor is cheap and/or natural resources are abundant. This kind of Japanese foreign direct investment is hence trade-oriented. Kiyoshi Kojima views most

Japanese foreign investment as "trade-creating, motivated by both economic incentives and conscious policy of the Japanese government to export low-wage (and polluting) industries to (primarily) the developing countries... Instead, most U.S. foreign investment (aside from raw materials) takes place near the top of the product cycle." <sup>11</sup> Under trade-oriented investment, host countries' production frontier expands in such a direction that the comparatively advantaged sector expands and the comparatively disadvantaged industry contracts.

## 2. Exchange Rate Advantages

Differences in exchange rates among countries and even the change in exchange rate within a country in different period of time are important to foreign investment decision-making.

The holder of debt denominated in a particular currency bears the risk that his returns will be reduced if that currency depreciates in value relative to other currencies. The change of interest rate of the debt-denominated currency

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11. See Kiyoshi Kojima, Japanese Direct Foreign Investment: A Model of Multinational Business Operations (Tokyo: Charles E. Tuttle, 1978), pp. 134-51. And "Direct Foreign Investment: Japanese Model versus American Model", in C. Fred Bergsten (ed.), Toward a New World Trade Policy: The Maidenhead Papers (Lexington Books, 1975), pp.6-7.

may reflect the change in value of the currency. Since MNCs are multiple currency-earners, such earnings are subject to exchange risk if converted back to home-country currency.

The Bretton Woods fixed exchange rate system greatly promoted international trade as well as greatly facilitating foreign direct investment. The Bretton Woods system imposed no risk of foreign exchange losses on foreign capital and its earnings and made the calculation of costs and profits possible.

With the collapse of the Bretton Woods system, the volatility of exchange rates during the last decade brought an additional dimension to the problem of a MNC's cost advantages. Wild fluctuation of exchange rates can either totally wipe out cost advantages or can suddenly make some manufacturing locations more attractive. The strength of the dollar during the last part of 1984 and 1985 suddenly rendered manufacturing in Europe particularly attractive.

The strength of dollar and the stable exchange rates are at least partially responsible for the rapid increase of foreign direct investment of the U.S.'s MNCs during the 1960s. The surge of US foreign direct investment during this period, reflected that the dollar was becoming increasingly overvalued. The overvalued dollar made the European countries

attractive; while the undervalued dollar would attract foreign MNCs like European and Japanese MNCs to invest in the United States because of the relatively cheap U.S. resources in terms of foreign currencies.

The cheap dollar exchange rate since mid-1980s, the size of American market, the stability of U.S. political environment, the fear of rising protectionism, the abundance of U.S. resources, and the increasing foreign labor costs contribute to the surge of foreign investment (Japanese in particular) in the United States in recent years.

A strong yen, the fear of protectionism and the fear of losing markets will force Japanese MNCs to locate plants elsewhere to take advantage of the strength of yen and other advantages available.

However, it must be recognized that exchange rates often vary, the advantages switch over time, as the case of labor cost advantages. Labor costs do not always stay unchanged and the competitive advantages derived from low labor costs can disappear over time, as in the case of Singapore and some other newly-developed countries. Since exchange rates fluctuate, MNCs could and should have not only a portfolio of manufacturing locations but also the flexibility to vary the loads assigned to its various manufacturing locations on short

notice through integrated operation.

### **3. Interest Rate Differences**

Another factor affecting the cost of investment is interest rate. The differences of interest rate of a country relative to other countries contribute to capital inflow or outflow. And the change of interest rate may lead to the change of exchange rate.

Since 1970s, the interest rates have been especially volatile, and this has a further impact on MNCs' activities. The uncertainty of capital cost has made the capital allocation difficult. However, MNCs are able to borrow at lower interest rates through international financing; moreover, they are able to borrow hard currencies which are highly valued by the markets because they tend to be fairly large firms and are hence considered less credit-risky. Therefore, the access to world credit markets by MNCs makes it possible to lower borrowing costs; to offset the exchange risk and to finance with lower interest rates.

### **4. Scale and Technological Advantages**

Cost advantages accrue to manufacturers who use the best technologies. Productivity advantages accruing from better utilization of equipment, materials and labor can add an additional cost advantage.

One motivation of foreign direct investment is to increase the utilization of firm's special advantages. Joe Bain suggested that the sources of the advantages involved superior production techniques, imperfections in input markets which allow lower buying prices for established firms, and first-mover advantages.

A vertically integrated MNC controls different stages of production process which takes place in different countries. One common kind of vertically integrated MNC is a manufacturing firm with a marketing or distribution subsidiary; another is a refining or processing firm which controls its foreign sources of raw materials to secure supply and reduce uncertainty.

The rationale for vertical integration stems from the efficient functioning of internal production and distribution systems. Vertical integration allows an increase in output, and can make a substantial contribution to economic efficiency through economies of scope and lower transaction costs. Vertical integration allows specialized cost-saving equipment to be installed in both upstream and downstream locations with less risk.

A horizontal MNC, producing the same or similar product

in different countries, has both cost-saving and revenue-enhancing properties. Horizontal integration can generate large economies of scale and increase market power for the MNCs. Direct foreign investment will be selected where difficulties such as the ability to price know-how, or to write, execute, and enforce restrictions governing technology transfer arrangements are anticipated.

The superior technology of the MNCs includes certain firm-specific activities like research, organization and marketing. These activities give rise to multi-plant scale economies<sup>12</sup> that give MNCs a cost advantage. Branch plant production is encouraged by the existence of international transportation costs and the economies of scale in marketing. Branch plant production occurs if firm-specific and export costs like tariffs are large relative to plant scale economies.

Markusen argues:

Sources of multi-plant economies are often found in firm-specific as opposed to plant-specific activities. These firm-specific activities include things like R&D, advertising, marketing, distribution and managerial services... One characteristic of these activities... is that they often involve a "public good" or "jointness" aspect with respect to the firm's various production

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12. For detailed discussion of multi-plant economies, see James R. Markusen, "Multinationals, Multi-plant Economies, and the Gains from Trade", Journal of International Economics, 1984, pp. 205-226.

facilities. R&D expenditures on designing better products and/or production processes provide an interesting example. Once an innovation is made, it can be incorporated into any number of additional plants without reducing the marginal product of that innovation in existing plants. The efficiency advantage of the multi-plant firm... lies in its ability to avoid the duplication in R&D and other activities which is necessarily involved in single-plant operation.<sup>13</sup>

MNCs compete technologically. Multinationals invest in R&D to lower costs, to develop new products and/or to improve the existing production process. The amount MNCs spend on R&D determines their position in a later competition in actual product markets. Note that the MNCs often tend to centralize these firm-specific activities, R&D, marketing, finance, etc. are often centralized in a particular location (like headquarters), while production activities are geographically dispersed. Similarly, communication among different managerial and technical departments is more efficient in a centralized location.

The need for centralized management of geographically dispersed activities may also lead to building large-scale, highly specialized plants to realize economies of scale. Strategic coordination, the central management of resource commitments across national boundaries in the pursuit of a global strategy, is essential to provide competitive and

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13. Ibid. p.207.

strategic coherence over time by headquarters and various subsidiaries in multiple countries. Coordination decisions transcend that of a single subsidiary. By strategic coordination, the MNC is able to recognize, build, and defend long-term competitive advantages. Typical examples would be coordinating R&D priorities, coordinating pricing to global customers, and, facilitating transfer of technology from headquarters to subsidiaries and among subsidiaries.

Large MNCs can spread the R&D costs and fixed costs of management over several markets with large volume and therefore they have lower unit costs. MNCs following a strategy of integration can best benefit from economies of scale in both production and marketing. A study shows that in petrochemical manufacturing, integration can save 20 per cent on the manufacturing costs of a MNC firm.<sup>14</sup>

## **5. Multinational Markets and the Economies of Scope**

A MNC can use its multinational market presence to cross-subsidize a competitive market. A MNC with a large family of products can subsidize a given business within a market and better service different national markets because product differentiation can meet different demands. Moreover, the MNC could have greater economies of scope with its distribution

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14. See Yves Doz, Strategic Management in Multinational Companies (Oxford: Pergamon Press, 1986), p. 20.

system, and can also introduce products with less incremental cost.

As mentioned earlier, vertically integrated MNCs could generate economies of scope. Production of the differentiated products of MNCs can share many same inputs like headquarter service to reduce unit cost. A MNC that produces finished goods can use its shared inputs to service the production of middle products. This is a reasonable assumption for manufactured goods which require similar technologies in the production of components and final assembled products. This feature of production generates an incentive for vertical integration; the incentive is strengthened when intermediate inputs are produced under increasing returns to scale.

## **6. Transfer Pricing Strategy**

Intra-firm trade of the MNCs, the sale of goods and/or services from one affiliate to another within the system of the MNC, accounts for a significant part of world import and export, especially intermediate goods.

Since intra-firm trade is not subject to the discipline of the market, the MNC can set prices at a level to maximize corporate profit. MNCs manipulate transfer prices to shift funds to higher interest-rate centers, to avoid controls on profit repatriation, and to circumvent local tax rules, tariffs and exchange controls by switching funds

to Tax Havens.

#### IV. Revenue-enhancing Strategies of MNCs

The concern of MNCs in managing output prices is simply this: how to maximize profits? Since demand differs in different markets, there are significant differentials for the optimum price of the same product in different markets. The MNC could maximize profits for the system as a whole by setting prices at levels according to the different local demand function, local costs, and local competition.

Economic efficiency calls for specialization, and the greater the degree of specialization, the larger the market is required. Firms with larger market shares are likely to be lower-cost producers, and the low-cost position provides the potential for larger profit. An increase in market demand will have a positive influence on the profit of firms operating in the market.

The revenues of MNCs are affected by market structure and by brand-name preferences:

##### **1. The Structure of Markets**

The market of each country is unique in terms of its competitive structure. The prices in various markets depend upon the number and the type of competitors. National firms,

operating in a protected market, can charge much higher prices than in an open and competitive market. Furthermore, if a market is supply-constrained, if the product is in the early stages of product development, one could reasonably expect that MNCs will charge a higher price.

Note that prices are constrained by market structure, competitive rivalry, and competitors' strategic intentions. As noted earlier, international market share of MNC is an important determinant of the MNC's revenue. In order to exploit the market asymmetries, the MNCs could and should develop a multinational market network. The need for a multinational-market is strengthened under global competition.

Nevertheless, the existence of MNCs may change the market structure. Foreign branch plants may serve to preempt foreign competition and deter entry in the host country. One interesting aspect of MNC is that an MNC branch plant provides certain goods to the host-country market, so the investment strategies of MNCs take account of the output allocations as well as future entry conditions.

Most economists agree that MNCs operate in oligopolistic markets. The theoretical underpinning comes from the pioneering work of Hymer (1960), Kindleberger (1969), and

Richard Caves (1971).<sup>15</sup> A MNC is both a result of market imperfection as suggested earlier, and a creator of imperfect market structures by increasing market concentration, product differentiation, and various barriers to entry.

The formation of a multinational market network poses significant barriers to entry of indigenous firms.<sup>16</sup> MNCs are large and advantaged in overcoming barriers to entry, because they possess assets which can preclude the entry of domestic firms: technical expertise in product or process development, managerial skills, product differentiation, networks of financing and marketing, advertising, and R&D. Economies of scale and large capital requirements also serve as impediments to the entry of new firms.

Markusen argued that a MNC always has an incentive to operate a host-country branch plant prior to entry by any local host-country firm.<sup>17</sup> If the market is a natural monopoly, preempting entry will create a monopoly for the MNC

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15. For further discussion of the oligopolistic character of MNCs, see Kindleberger and Audretsch, (eds.), The Multinational Corporation in the 1980s (Cambridge: The MIT Press, 1983), p. 166.

16. Ibid. p. 44.

17. For more detailed discussion of entry-preemption strategy, see Ignatius J. Horstmann and James R. Markusen, "Strategic Investments and the Development of Multinationals", International Economic Review, February, 1987, pp. 109-121.

for all future periods. It earns profits each period strictly larger than the sum of profits for the entrant and which would result should it not preempt entry. The MNC, therefore, operates a host-country branch plant and so captures all the rents available in the market rather than just a share of them. If complete preemption is not possible, MNC can set up strategic barriers to entry by utilizing an excess-capacity strategy. The MNC can therefore delay entry simply by adding an additional plant each time entry is threatened.

## **2. The Value of Brand-Name Preference and marketing**

Well-established brands with a quality image command a price premium. Brand loyalty which some MNCs possess gives them an advantage. One would argue that the basic television set is an engineered commodity and the quality differential between established manufactures like Sony and a new comer like Samsung is trivial. However, Sony is able to obtain significantly higher prices than Samsung. The established reputation of quality and image serve as extra advantages for MNCs like Sony Company.

The MNC's control over distribution channels brought about by a product line can allow for a premium. MNCs often have marketing channels in place and have better knowledge about the different preferences and demands in various national markets. MNCs' subsidiaries can develop their own brand and

distribution presence. As a result of local responsiveness strategies, MNCs could have better local adaptation of products or differences in distribution across national markets.

#### V. The Home Country and MNC

A MNC creates some problems for its home country. Does the foreign direct investment of MNC contribute to unemployment in the home country? Does the home country government tax the MNC fairly?

The actual impact of foreign investment on employment is quite difficult to estimate. Foreign production may displace some home-country workers, but it also creates a demand for labor by MNC for exports from plants based in home country, and for administrative employment at home.

Enders and Lapan contend that the impact of overseas investment on employment in home country depends on a number of factors, including why the investment occurred and what special advantages the MNC possesses. In some cases this investment is defensive. For example, if increased foreign tariffs make it impossible to service the foreign market through exports from the home country, the MNC must produce abroad to circumvent the "tariff-walls" or it will lose the market. In other cases the MNC may produce abroad to service

the home country because of the lower labor costs abroad. The lower labor costs abroad undoubtedly threaten the jobs and wages in the home country like the United States, but even if US MNCs are banned from investing in the low-cost areas, European or Japanese MNCs will, and US jobs may be lost in any event. They further argued that unemployment is not due to foreign investment or imports, but rather to the failure of domestic wages to adjust to changes in labor demand.<sup>18</sup>

MNCs tend to locate their production activities in low-production-cost countries. The differences in national tax rates affect the production costs. The ability of MNCs to escape taxation by transferring production abroad limits the ability of home country to tax those firms. MNCs raise difficult taxation issues. They are able to avoid or reduce taxes by shifting profits to low-tax "tax-haven" countries. The difficult issues for the home country are how to tax foreign MNCs operating within the home country and how to tax profits earned by the foreign subsidiaries of domestic MNCs.

On the other hand, the foreign direct investment of MNCs is affected by their home countries' policies. Home countries may restrict or encourage foreign direct investment by their

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18. For further detail see Walter Enders and Harvey E. Lapan, International Economics (New York: Prentice-Hall, Inc., 1987), pp. 225-226.

MNCs not only for economic reasons but also for political reasons. Antitrust law enforcement may reduce the competitiveness of the country's MNCs. Policies that limit the technology transfer and investment in certain areas or certain industries may actually forbid foreign investment. Government income policies and tax policies can also serve as instruments to influence investment decision-making. Allowing MNCs to defer taxes on foreign profits is like an interest-free loan and encourages overseas investment.

There has been criticism of the lack of U.S. government aid for the U.S.-based MNCs, and of the restrictions which make them less competitive overseas with their European and Japanese rivals.

However, home governments may provide a helping hand occasionally. Subsidies and special privileges such as access to public sector markets, export credits, information concerning the political stability of host countries and favorable monetary and fiscal policies can enhance MNCs' competitive muscle and staying power.

#### VI. The Host Country and MNC

Recipient host countries' policies toward MNCs play a crucial role in the investment-decision-making of MNCs. They

can have a determining impact on the corporate return, on the MNCs' worldwide competitive position, and on the global strategic posture over time.

Since many MNCs are huge, the distributional and allocative effect of MNCs on world welfare cannot be ignored. On the one hand, MNCs may increase a host country's welfare through economic development and the improvement of economic efficiency; on the other hand, MNCs may take all the economic benefit available in the host country. MNCs may use transfer pricing to escape control of both home and host governments.

Different countries have different policies toward MNCs. Some encourage foreign direct investment, aiming at managing and modifying industry structures and obtaining increased efficiency and economic welfare. Some have stringent rules regarding foreign investment. Even within the same country, different industries may face different requirements and these requirements may change over time. Some host countries feel that a wholly-owned subsidiary by a foreign parent company is unacceptable.

Host governments are constantly seeking ways to increase the benefits to their economies from foreign investment. Benefits of foreign direct investment include the development of industrial bases, job creation, on-the-job-training,

learning by doing, tax generation, export promotion, and other internal and external economies like improvement of efficiency and economic welfare. Host countries encourage MNCs to locate domestically because the foreign investment can create domestic employment, and infuse competition and advanced technology into the domestic economy.

Host government also realize the challenges posed by MNCs to national policies. MNCs' strategic decisions such as the location of investment, flow of intra-firm trade, technology transfer, location of R&D and employment have an impact on and are affected by national policies. Many MNCs are huge, with total sales exceeding the GNP of some host countries. They can have great influence on policy decisions of the host countries. Vernon characterized the loss of economic, cultural and political independence due to foreign control of domestic industry as "sovereignty at bay."<sup>19</sup>

Host governments often implement a number of measures<sup>20</sup> to protect their own national interests that limit the freedom of MNCs. The following are examples.

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19. See Raymond Vernon, Sovereignty at Bay: the Spread of U.S. Enterprises (New York: Basic Books, 1971).

20. For a detailed analysis, see C. K. Prahalad and Y. C. Doz, The Multinational Mission (New York: The Free Press, 1987), pp. 67-100.

1. Restrictive trade practices, including limits on the importation of goods, tariffs to discourage imports, minimum export volume requirements, and imposition of local content requirements.

2. Social benefit regulations, including appropriate technology requirement to improve employment, technology transfer in a certain time period, minimum wage rate for local workers, product standard and service availability requirements, and more importantly, price control policies used to improve host countries' welfare.

3. Non-tariff barriers like sophisticated product and technical standards, complicated product certification procedures, and specific product image requirements.

4. Restrictions on industry structure and competition, including limitations on foreign firms operating in certain sectors such as defense industry and other strategic material industries, limits on foreign investment in certain vital projects, restrictions on certain foreign acquisitions (in some extreme cases, host government may forbid acquisition of local firms), and requiring the MNC to enter a joint venture with local shareholders. (The joint venture partner will hamper the freedom of capital movement.)

5. Investment policies and constraints on divestitures, including limitations on capital transfer, profit reinvestment requirements to restrict capital outflow, limitations on percentage of a foreign subsidiary and limits on the amount of profits that the subsidiary may remit to the parent company (common in Latin American countries), foreign exchange controls to lock cash in certain countries, and discriminatory taxation policies in favor of local firms.

6. Requirement for local participation in the management, and requirements to use local workers and to purchase local inputs and components.

All of these measures hamper the freedom of the MNC.

Similarly, host governments may welcome MNCs and encourage them to invest in certain areas or certain industries where funds and technologies are needed. Host governments not only provide the legal and regulatory framework governing the business activities, like environmental protection, industrial relations, product standards and social security requirement for domestic and foreign firms, host governments can also create a favorable investment climate for foreign direct investment by offering tax breaks and import concessions. The improvement of infrastructure, including education, training to improve working-skill and building of transportation

facilities, attracts and facilitates foreign investment.

In the process of MNCs' investment strategy formulation, the host-country's goals, interests, policies and actions should be considered. The political stability of a host country has an immense role in the decision to invest abroad by the MNCs. The local responsiveness strategy aims at the better adaptation to the local situation, including host government attitude toward foreign companies. As Mahini put it:

However, government policies designed to influence foreign subsidiaries to respond to national goals and objectives force MNCs to effect a variety of compromises, adaptations, and changes in their strategies. At the extreme, ...company strategy may be influenced in a fundamental and deterministic way in the direction of country-oriented, nationally responsive subsidiaries. Such adaptation in strategy is most likely to occur in the manufacturing sector in which a prime purpose of a subsidiary is to serve the needs of the local market. In the natural resource sector, on the other hand, the prime function of this subsidiary is to serve the international market by the export of raw materials and the scope for such fundamental adaption of strategy is not great.<sup>21</sup>

The compromise reached between MNCs and nation-states are dependent on their relative bargaining power. The allocation of bargaining power determines the degree of

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21. Amir Mahini, Making Decisions in Multinational Corporations (New York: John Wiley & Sons, 1988), p. 198.

government intervention. In the words of Poynter,

The allocation of bargaining power is determined by which party has control over, or access to, factors which are perceived to influence the continued success of the subsidiary in question. The MNE and the host nation compete in the supply of product and process technology, and managerial skills... MNEs usually have complete control over the intra-MNE sourcing and exports, while the host controls access to its home market.<sup>22</sup>

## VII. The Emergence of MNCs from Developing Countries

In recent years, one striking feature of the development of MNCs is the growing number of MNCs from developing countries, mostly from newly industrializing countries like South Korea, Taiwan, Singapore, Hong Kong, Brazil, and Argentina.

The motivations for firms from developing countries to become multinational are essentially similar with those of MNCs from industrialized countries: to reduce costs, to secure supply of raw materials, and to increase market share.

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22. Thomas A. Poynter, Multinational Enterprises and Government Intervention (Worcester: Billing and Sons Limited, 1985), pp. 132-133.

One would expect MNCs investing in LDCs to employ processes suited to the factor proportions in the LDCs to maximize their profits. But evidence indicates that MNCs from developed countries tend to bring with them and to use the production techniques from their home countries. Those technologies are not appropriate for LDCs with little capital and abundant labor supply. There is thus a niche for LDCs' investors who offer investment projects suited for efficient, small-scale manufacturing and for less expensive, labor-intensive technology.<sup>23</sup>

MNCs from LDCs may employ labor-intensive processes more readily than other MNCs. The small-scale manufacturing industries provide special opportunities for LDC investors because economies of scale and capital-intensive technology, which are the dominant feature of MNCs from developed countries, are less often necessary. The LDC multinationals may offer not only more appropriate technology but also smaller, more efficient operations and therefore contribute more fully to economic development. One particular feature in LDCs is the small size of the market. Faced with small markets for many products, investors in LDCs can increase profits if they can adapt technology to small-scale manufacturing.

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23. For further discussion, see Theodore H. Moran (ed.), Multinational Corporations (Lexington Books, 1985), p. 18.

Another major difference that distinguishes MNCs of developed countries from those of LDCs is flexibility. MNCs from LDCs are able to respond to the market demands quickly by providing a variety of products. Machines, equipments are designed or chosen for their flexibility, plants are relatively small-scale but efficient. The design of a flexible, small scale plant is determined by the equipment suppliers both in the developed countries and in the developing ones.<sup>24</sup>

Also, low overheads give many developing countries' MNCs a strength that supports their ability to manufacture at small volumes with low unit costs.

### Summary

The primary motivation for direct foreign investment by MNCs is the pursuit of profit. Through adopting global strategies, MNCs compete with international competitors on international markets. Cost-saving strategies and revenue-

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24. See Louis T. Wells, Jr. "Small-scale Manufacturing is a Comparative Advantage", Theodore H. Moran, (ed.), Multinational Corporations (Lexington: Lexington Books, 1985), pp. 119-138.

enhancing policies are critical considerations for MNCs to directly invest abroad.

Cost-saving strategies involve the elements of lower factor costs, availability and access to the cheap and plentiful natural resources, exchange rate advantages, the difference of interest rates, and most importantly the economies of scale and the economies of scope through coordination, horizontal and vertical integration worldwide.

Revenue-enhancing strategies include the utilization of imperfection of market system or the failure of global market, the attempt to enlarge market share, setting up brand-name images and building global distribution system, product family policy, and using strategic barriers to preempt entry of potential competitors. Transfer pricing also plays an important role in increasing the profits of MNCs.

Other considerations are both home and host governments' policies and their short-run and long-run objectives. MNCs which pursue proper strategies of reducing costs and enhancing revenues, and of fitting host-countries' goals and interests can, effectively compete with other rivals and thrive on the world market.

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## **Abstract**

This paper examines the advantages and motives of foreign direct investment by Multinational Corporations (MNCs) from the perspective of Industrial Organization and International Economics.

As a firm, a MNC's primary motivation for being multinational is profit maximization. The unique structure of MNCs makes it possible to exploit the imperfect markets and the firm-specific advantages through the strategies of global integration or local responsiveness. Along with the organizational and technological advantages, large economies of scale and economies of scope can be generated because of horizontal and vertical integration.

Location of production at lower-factor-cost regions, the availability of and access to cheap and abundant natural resources, the utilization of exchange rate and interest rate advantages, all contribute to the reduction of production costs and the higher profitability of the MNCs. Meanwhile, the manipulation of the imperfect market system and their marketing strategies may increase their market shares and profit margins.

Both home and host countries' policies play an important role in the MNCs' decision to invest overseas. Both home and host countries are concerned about their own economic and political interests. The compromise between MNCs and host-countries is dependent upon the relative bargaining power of

the two sides.

Finally, the recent emergence of MNCs from the developing countries adds a new dimension in the development of multinationals.